**IN THE MATTER OF**

**THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL**

**- and -**

**(1) GRANT THORNTON UK LLP**

**(2) SIMON LOWE**

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**SUMMARY**

**OF EXECUTIVE COUNSEL'S DECISION NOTICE**

**Pursuant to Rule 18 of the Audit Enforcement Procedure**

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***This summary of the Decision Notice is a document prepared by Executive Counsel and agreed by the Respondents, following an investigation relating to, and admissions made by, the Respondents. It does not make findings against any persons other than the Respondents and it would not be fair to treat any part of this document as constituting or evidencing findings against any other persons or entities since they are not parties to the proceedings.***

## 1. INTRODUCTION

1.1. The Financial Reporting Council (the "**FRC**") is the competent authority for statutory audit in the UK and is responsible for the operation of the Audit Enforcement Procedure (the "**AEP**"), effective from 17 June 2016. The AEP sets out the rules and procedure for the investigation, prosecution and sanctioning of breaches of Relevant Requirements (as defined therein).

1.2. This is a summary of the Decision Notice produced following the FRC's investigation into various issues arising out of the audits of the consolidated financial statements of Interserve plc (the "**Company**) for each of the years ended 31 December 2015 ("**FY 2015**"), 31 December 2016 ("**FY 2016**") and 31 December 2017 ("**FY 2017**") (the "**Decision Notice**"). Full details of the matters referred to below in connection with the FY 2015 and FY 2016 audits cannot be published due to the fact that these matters are intricately connected with information obtained from the Company during the audits that is legally privileged. In view of the fact that redaction would deprive the reader of necessary context and significantly hinder a reader in understanding the matters in issue, the Decision Notice has been published in summary form in order to make the issues more accessible.

1.3. The Respondents to the Decision Notice are:

1.3.1. Grant Thornton UK LLP ("**Grant Thornton**"), the Statutory Auditor of the Company's consolidated financial statements for FY 2015 to FY 2017; and

1.3.2. Simon Lowe, the Senior Statutory Auditor of the consolidated financial statements for FY 2015 to FY 2017 and a member of the Institute of Chartered Accountants in England and Wales in the relevant period.

1.4. Grant Thornton and Mr Lowe are referred to below as the "**Respondents**" or the "**audit team**" as appropriate.

1.5. The Decision Notice addresses breaches of Relevant Requirements admitted by the Respondents that arose in the context of the audit work conducted by the Respondents on the consolidated financial statements for the Company for FY 2015, FY 2016 and FY 2017.

1.6. Pursuant to Rule 16(b) of the AEP, the Executive Counsel has decided that the Respondents are liable for Enforcement Action, having made Adverse Findings against each of them in relation to the audit work performed on:

1.6.1. The forward loss provision ("**FLP**") in the financial statements for FY 2015 and FY 2016 against a contract for the construction of a waste treatment facility in Glasgow ("**the Glasgow Contract**"); and

1.6.2. The assessment of going concern and goodwill impairment in the financial statements for FY 2017.

1.7. For the avoidance of doubt, the Executive Counsel does not assert that the Company's financial statements for FY 2015 and FY 2016 were materially misstated in respect of the accounting for the Glasgow Contract, or that the Company's financial statements for FY 2017 were materially misstated in respect of the impairment of goodwill or that the going concern basis used in preparing the FY 2017 was inappropriate or subject to material uncertainty, and it should not be inferred from the admissions made by the Respondents that any material misstatement occurred.

## 2. BACKGROUND

The Company

2.1. The Company was a UK-based global construction and support services group. The group consisted of six main divisions: Support Services, Construction, Equipment Services, Developments, International and Group Services. Support Services and Construction were the largest two divisions, together accounting for over 90% of gross revenue. In FY 2015 it reported total revenue of £3.2 billion and a profit before tax of £79.5 million; and it employed 63,750 people worldwide. In FY 2016 it reported total revenue of £3.2 billion and a loss before tax of £94.1 million; and it employed 60,123 people worldwide. In FY 2017, it reported total revenue of £3.2 billion, and a loss before tax of £244.4 million; and it employed 55,350 people worldwide. The Company entered into administration on 15 March 2019.

### FY 2015 and 2016

The Glasgow Contract

2.2. Between July 2012 and March 2015, a subsidiary of the Company (the "**Subsidiary**"), won six *"energy-from-waste"* ("**EfW**") contracts, which provided for the construction of waste treatment facilities.

2.3. The Glasgow Contract was one of these contracts and was agreed in 2012. Under the terms of the Glasgow Contract, the Subsidiary contracted with a company (the "**Employer**") for the Subsidiary to build a waste treatment facility in Glasgow (the "**Glasgow Contract**").

2.4. In turn, the Subsidiary sub-contracted with two companies to design and build an Odour Control System ("**OCS**"; the "**OCS Subcontractor**") and the Advanced Conversion Facility ("**ACF**"; the "**ACF Subcontractor**").

2.5. Across the Construction and Support Services divisions, the audit teams (comprising more than two dozen individuals) between them reviewed 87 contracts in the FY 2015 audit and 78 contracts in the FY 2016 audit. The EfW contracts were identified as a significant risk, and the Glasgow Contract was the subject of specific audit consideration, in both audits. In both FY 2015 and FY 2016 the Glasgow Contract was loss making: in FY 2015, non-recurring losses of £28.7 million were recognised in relation to this contract. In FY 2016 it accounted for £91.4 million of a £160 million exceptional loss relating to EfW. The Glasgow Contract raised particular issues for the audit team to consider in relation to liabilities resulting from the termination of the Glasgow Contract by the Employer and in relation to the two substantial claims being made by the Subsidiary under its professional indemnity insurance arising out of the work of subcontractors (the OCS Claim and the ACF Claim).

The OCS Claim

2.6. In 2015 the OCS Subcontractor entered administration, and its contract was terminated by the Subsidiary.

2.7. Shortly thereafter, the Subsidiary formed the view that the ductwork forming part of the OCS Subcontractor's design was not fit for purpose and would need to be redesigned and re-fabricated. The cost of rectifying the defects, the delay damages payable to the Employer which were attributable to the OCS Subcontractor, and other associated losses and costs were the subject of a notification to the Subsidiary's professional indemnity insurers in October 2015 (the "**OCS Claim**").

2.8. The total amount recorded as recoverable from insurers against the OCS Claim in the financial statements for FY 2015 was £17.7 million.

2.9. The figure of £17.7 million included sums which were highly fact-sensitive and unsupported by expert evidence. The Company's management nevertheless considered the inclusion of those sums to be justified on the basis that although no expert report had been obtained, third-party engineers had provided support for the claims.

Termination of the Glasgow Contract

2.10. In 2016, following extensive critical delays to the project, the Employer terminated the Glasgow Contract with the Subsidiary.

2.11. In its consolidated financial statements for FY 2016 the Company included a FLP of £126.9 million against the expected loss on the Glasgow Contract. Two elements of the FLP are of particular relevance, namely (i) estimated amounts payable to the Employer on termination in the sum of £53.8 million; and (ii) income to be derived from claims in the sum of £65.9 million.

Amounts payable to the Employer on termination

2.12. The Company estimated that £53.8 million would be payable to the Employer following termination of the Glasgow Contract.

2.13. This figure was based on a calculation of the Subsidiary's maximum potential liability under the terms of the Glasgow Contract, taking as its starting point the cap on liability imposed in the contract, and then deducting a sum for work still to be performed, before taking account of the contractual allocation of responsibility under a "pain share clause" between the Employer and the Subsidiary for losses arising out of delays attributable to the ACF Sub-contractor in particular circumstances that had arisen.

2.14. The alternative basis for this estimate was the Company's calculation of the Employer's likely costs to completion. The estimate of £53.8 million calculated on this alternative basis comprised four elements of cost. One of these elements was a round figure of £15,000,000 representing *"[Employer] on-costs for managing to completion*", which was described in the audit team's working paper as a "*Guesstimate of on costs incurred by [the*

*Employer] in completion of the works. Broadly, this figure has the £54m above in mind*."

2.15. On 7 February 2017 the Employer submitted its initial termination account, which contained a total estimate of costs to complete of c.£88 million, an amount above the Liability Cap. The Employer did not refer to or apply the Liability Cap in its calculation. Rather, it deducted sums owed to the Subsidiary for work already performed. This produced a net estimate of compensation payable of c. £63 million, an amount which fell below the Liability Cap. A possible interpretation of the Employer's calculation was that the Employer's approach to the Liability Cap was to apply it not to the estimate of total costs to complete, but rather to that estimate less the sums owed for work performed. Such an approach would have resulted in the Subsidiary's maximum potential liability being significantly higher than anticipated.

<u>Income from claims</u>

2.16. For the purposes of the financial statements in FY 2016, the Company estimated that the Subsidiary would recover £65.9 million in respect of its subcontractors' alleged failings, either by claiming under its professional indemnity insurance or pursuant to the pain share clause in the Glasgow Contract.

2.17. Of the total estimated recovery of £65.9 million, the Company's management estimated recoveries of £17.5 million under its professional indemnity insurance in respect of alleged failures by the OCS Subcontractor and £22.4 million in respect of alleged failures by the ACF Subcontractor.

*The OCS Claim*

2.18. A figure of £19.5 million less the £2 million excess was recognised in respect of the recoveries that the Company expected the Subsidiary to make in the OCS Claim in the FY 2016 consolidated financial statements.

2.19. To reach this figure, the Company first calculated the total liability incurred by the Subsidiary as a consequence of the allegedly faulty designs. Recovery factors (the "**Recovery Factors**") were then allocated to the various elements of the total costs. The Recovery Factors were based on discussions with a technical expert instructed by the Subsidiary's professional indemnity insurers (the "**Expert**").

2.20. The Company then applied a *"Stretch Target"*, representing an additional recovery that it wished to make in respect of the OCS Claim.

*ACF Claim*

2.21. As to the ACF Claim, the Subsidiary calculated that its maximum potential liability to the Employer (including costs the Subsidiary had already incurred) was £87,574,275.

2.22. The Subsidiary obtained legal advice from a barrister. The Company then applied factors to the various categories of direct cost (*i.e.* costs excluding preliminaries).

2.23. After the application of these factors, the total recoverable direct cost was assessed at £13,604,456. For each category of direct cost which had been applied, the Company then calculated the relationship between the total recoverable cost and the total costs; and assumed that preliminaries were recoverable in the same proportions to the applied categories of direct costs. On this basis, the total value of recoverable preliminaries was £10,853,496. This increased the total recoverable costs to £24,457,952. Net of the excess of £2,000,000 this gave an estimated recovery from the Subsidiary's PI insurers of £22,457,952.

2.24. This was not materially different from the recoverable figure of £22,360,000 adopted in the FLP.

**FY 2017**

2.25. The arrival of a new CEO and CFO in September and October 2017, with plans to restructure the group, coincided with profit warnings being issued by the Company to the market. By November 2017 Interserve had announced and embarked on a restructuring plan called “Fit for Growth”. At around this time, the Company also entered into discussions with lenders for new long-term credit facilities. These discussions did not conclude until 27 April 2018, when the refinancing agreement was signed, following which Grant Thornton issued its concluding report to the Audit Committee and the audit report was signed.

2.26. In order to comply with the Listing Rules, the financial results for the Company for FY 2017 had to be issued within four months of that year end (i.e. by 30 April 2018).

2.27. The financial statements for FY 2017 were prepared on a going concern basis. The period selected for the going concern review by the management of Interserve was twelve months from the date the audit report was signed.

2.28. The Viability Statement in the Annual Report covered a period of three years from the balance sheet date and contained over three pages of disclosures. It included further disclosure relevant to the Company’s ability to continue as a going concern during the going concern period. It also referred to a number of material uncertainties in the latter part of the three year viability review period. The Viability Statement concluded of the Group: “*there can be no certainty that it will remain viable and there are credible scenarios identified in which it will not remain so*. *The directors have a credible plan which they are implementing but they acknowledge the inherent risks of delivery, some of which are outside their control*.”

2.29. The audit opinion was unqualified. The Auditor’s Report did not contain a “material uncertainty with regard to going concern” paragraph, and drew attention to the Viability Statement disclosures.

2.30. An impairment of £60m was recognised against goodwill in FY 2017 in respect of the Company’s Private Sector FM business.

The audit of going concern

2.31. For the FY 2017 audit, going concern was classified as a significant risk. At the planning stage of the audit, the audit team engaged internal restructuring experts (the "**Restructuring Team**") to consider the impact of the proposed refinancing, assess the risks relating to the possible breach of banking covenants, and assist with the detailed review of forecasts. The documentation on the audit file records that Grant Thornton spent about 2,000 hours working on going concern. That time was predominantly incurred by the Restructuring Team. The audit team evaluated the adequacy of the work conducted by the Restructuring Team, and discussed the Restructuring Team's conclusions with the Company's management and the Audit Committee.

2.32. The assessment of going concern and viability was conducted by reference to Interserve's forecasts covering a three-year period to 31 December 2020, known as the "**Business Plan Model**". This contained three forecasts: the Base Case (derived from divisional budgets and aggregated using the Company's Hyperion reporting system); the Sensitised Case (which was the Base Case adjusted for various sensitivities); and the Restructuring Case (which was the Sensitised Case adjusted to reflect expected cashflows from the "Fit for Growth" plan). The Restructuring Case was the forecast provided to the Company's lenders and used by them in considering the request for refinancing which was ultimately agreed; the refinancing terms required the Company to update the lenders on progress in implementing the "Fit for Growth" plan.

2.33. The "Covenant Model" was provided to Grant Thornton on 17 April 2018, in the later stages of the Company's refinancing negotiations. This was an updated version of the Restructuring Case prepared by the Company, adjusted to reflect revised prospective covenants, increased financing costs and additional costs.

2.34. The Restructuring Team also prepared the "Grant Thornton Case", which applied a number of sensitivities to the Restructuring Case. This has been described by Grant Thornton as a "*single downside scenario*", but not "*a likely scenario, as it assumed that a large number of adverse developments would coincide*".

Unreconciled differences

2.35. The Restructuring Team undertook various reconciliation exercises in respect of cashflow and working capital and identified a number of unreconciled differences. These included:

2.35.1. Unreconciled differences between projected working capital movements and projected balance sheet movements; and

2.35.2. Unreconciled differences between historical cash flow results for FY 2015 and FY 2016 and the corresponding statutory accounts.

Goodwill impairment

2.36. Goodwill impairment was identified as a significant risk for the FY 2017 audit.

## 3. RELEVANT REQUIREMENTS

3.1. Rule 1 of the AEP states that "*Relevant Requirements*" has the meaning set out in regulation 5(11) of the Statutory Auditors and Third Country Auditors Regulations 2016 ("SATCAR"). Those requirements include, but are not limited to, the International Standards on Auditing (UK and Ireland) ("ISAs") issued by the FRC.

3.2. The ISAs relevant to the Executive Counsel's Final Decision Notice are those effective for audits of financial statements for periods ending on or after 15 December 2010.

3.3. The Relevant Requirements referred to in this Final Decision Notice are the following:

3.3.1. Paragraph 15 of ISA 200. This provides that: "The auditor shall plan and perform *an audit with professional skepticism* *recognizing that circumstances may exist that cause the financial statements to be materially misstated".*

3.3.2. Paragraph 8 of ISA 230. This provides that: *The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:*

*The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK) and applicable legal and regulatory requirements;*

*The results of the audit procedures performed, and the audit evidence obtained; and*

*Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.*

3.3.3. Paragraph 18 of ISA 315 (revised in June 2016). This provides that: "*The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:*

*(b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements…*"

3.3.4. Paragraph 6 of ISA 500. This provides that: "*The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence*".

3.3.5. Paragraph 6 of ISA 540. This provides that: "*The objective of the auditor is to obtain sufficient appropriate audit evidence about whether: (a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable; and (b) related disclosures in the* *financial statements are adequate, in the context of the applicable financial reporting framework*".

3.3.6. Paragraph 15 of ISA 540. This provides that:
"*For accounting estimates that give rise to significant risks… the auditor shall evaluate the following:*
*How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.*
*Whether the significant assumptions used by management are reasonable.*"

3.3.7. Paragraph 12(c) of ISA 620. This provides that:
"*The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including: If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.*"

## 4. ADVERSE FINDINGS

4.1. In light of the matters set out above, the Respondents have admitted the following Adverse Findings.

**Adverse Finding 1: The OCS Claim in FY 2015**

4.2. The sum of £17.7 million less the policy excess of £2 million was recorded in the consolidated financial statements for FY 2015 in respect of the OCS Claim. However, this estimated recovery was not supported by adequate expert evidence that the claim being recognised by the Company was likely to be recoverable in full.

4.3. In these premises, the audit team breached the Relevant Requirements. In particular, in breach of paragraph 15 of ISA 200, the audit team failed to exercise sufficient professional scepticism. They ought to have challenged the Company's decision to recognise all of the losses and costs said to be attributable to the deficiencies in the work of the OCS Subcontractor in circumstances where (among other things) there was limited evidence to support the conclusion that as a matter of fact all of the losses and costs were recoverable.

**Adverse Finding 2: Amounts payable to the Employer for delay in FY 2016**

4.4. The Company approached the calculation of the total sum payable to the Employer on termination on a different basis to the Employer.

4.5. The divergence in approach between the Company and the Employer had the potential to have a material impact on the FLP against the losses on the Glasgow Contract. The audit team gave insufficient consideration to a potential alternative interpretation of the terms of the Glasgow Contract.

4.6. Further, inadequate audit work was conducted on management's estimate of the costs that the Employer could reasonably be expected to incur in completing the project. As noted above, one element of this estimate was £15,000,000 representing *"[Employer] on-costs for managing to completion"*, which was expressly described as a "*guesstimate*".

4.7. In these premises, the audit team breached the Relevant Requirements. In particular:

4.7.1. In breach of paragraph 15 of ISA 200, the audit team failed to exercise sufficient professional scepticism. They ought to have challenged the Company's approach to the application of the liability cap in the Glasgow Contract; and they ought to have sought further evidence in support of the "*guesstimate*" of the costs that the Employer could reasonably be expected to incur.

4.7.2. In breach of paragraph 6 of ISA 540, the audit team failed to obtain sufficient appropriate audit evidence as to whether the estimate of the Subsidiary’s liability to the Employer was reasonable.

**Adverse Finding 3: The OCS Claim in FY 2016**

4.8 The FLP against the Subsidiary’s liability under the Glasgow Contract in respect of FY 2016 included an estimated recovery of £17.5 million under the Subsidiary’s professional indemnity insurance for work conducted by the OCS Subcontractor. However:

4.8.1 There was no consideration recorded on the audit file of the extent to which the underlying evidence, in the form of the legal advice obtained by the Company (and the instructions to its barrister) and the views expressed by the Expert, provided direct support for this estimated recovery. In fact, the Company’s basic position on recovery in respect of one of the four heads of loss was contradicted by some of this evidence.

4.8.2 The Recovery Factors used by the Subsidiary were not agreed by the Expert but were instead based on the Subsidiary’s interpretation of his opinion. However, there was no discernible link between that opinion and the Recovery Factors chosen.

4.8.3 The “*Stretch Targets*” identified by management were unsupported by evidence. In one instance they resulted in an estimated recovery which exceeded the costs actually incurred.

4.9 In these premises, the audit team breached the Relevant Requirements. In particular:

4.9.1 In breach of paragraph 15 of ISA 200, the audit team failed to exercise sufficient professional scepticism. They ought to have challenged the Company’s approach to potential recoveries under the OCS Claim, and to have sought further evidence in support of the Company's assertion that the Recovery Factors were achievable and sufficiently certain to justify their inclusion in the FLP.

4.9.2 In breach of paragraph 6 of ISA 500, there was not sufficient appropriate audit evidence in support of the Recovery Factors adopted by the Company.

4.9.3 In breach of paragraph 6 of ISA 540, the audit team failed to obtain sufficient appropriate audit evidence as to whether the estimated recoveries under the OCS Claim were reasonable.

**Adverse finding 4: The ACF Claim in FY 2016**

4.10 The FLP against the Subsidiary's liability under the Glasgow Contract included an estimated recovery of £22.36 million under the Subsidiary's professional indemnity insurance for alleged design defects on the part of the ACF Subcontractor.

4.11 As noted at 2.23 above, a factor was applied to direct costs incurred as a consequence of the defective design on the part of the ACF Subcontractor, which were divided into three categories.

4.12 The audit team considered the legal advice referred to at paragraph 2.22 above. There is, however, no adequate discussion on the audit file of the basis on which costs were allocated between the three categories of cost and the basis on which the estimated recovery for each category had been calculated.

4.13 Further, the estimated amount recoverable from the Subsidiary's professional indemnity insurers included £10,853,496 in preliminaries. The calculation of that amount assumed that preliminaries were recoverable in proportion to the recoverability of direct costs. There was no discussion on the audit file of the extent to which this assumption was justified.

4.14 In these premises, the audit team breached the Relevant Requirements. In particular:

4.14.1 In breach of paragraph 15 of ISA 200, the audit team failed to exercise sufficient professional scepticism. They ought to have challenged the Company's approach to, and sought further evidence in support of, the potential recovery against the ACF Claim.

4.14.2 In breach of paragraph 6 of ISA 540, the audit team failed to obtain sufficient appropriate audit evidence as to the elements of the estimated recovery.

**Adverse Finding 5: Hyperion in FY 2017**

4.15 In breach of paragraph 18 of ISA 315, in FY 2017 Grant Thornton did not perform sufficient work to obtain an understanding of the general IT controls on the Hyperion system used to aggregate the divisional budgets into the Base Case.

4.16 Further and in breach of paragraph 12(c) of ISA 620, Grant Thornton failed to complete an adequate evaluation of the source data derived from Hyperion, used by the Restructuring Team, for completeness and accuracy.

**Adverse Findings 6 and 7: Unreconciled differences in FY 2017**

4.17 As noted above, the Restructuring Team undertook a reconciliation exercise which identified various differences between the Company's projected working capital movements and its projected balance sheet movements in the Business Plan Model.

4.18 The audit file recorded that the audit team was unable to reconcile (i) differences between the Company's projected working capital movements and its projected balance sheet movements in the Business Plan Model; and (ii) differences between the Business Plan Model and the prior-year financial statements.

4.19 In breach of paragraph 6 of ISA 500, there is an inadequate record on the audit file of the consideration of the impact of these differences on the going concern review, or the extent to which they were mitigated or accounted for by the sensitivities applied by the Restructuring Team. In these circumstances, Grant Thornton failed to obtain and document sufficient audit evidence.

**Adverse Finding 8: sensitisation of impairment models in FY 2017**

4.20 In FY 2017, Grant Thornton applied various additional adjustments and assumptions to the Restructuring Case to produce the Grant Thornton Case. The Grant Thornton Case was used in the audit work on going concern. The audit team failed to apply relevant aspects of the Grant Thornton Case in order to sensitise the forecast margins used in the Company's impairment model in the audit of goodwill impairment.

4.21 This constituted a breach of paragraph 15 of ISA 540, in that Grant Thornton failed to challenge adequately the forecast margin used in management's assessment of impairment, and therefore adequately to evaluate whether the significant assumptions used by management were reasonable.

**Adverse Finding 9: failures of documentation in FY 2017**

4.22 Management's assessment of goodwill impairment was performed on the basis of the Restructuring Case. The Restructuring Case assumed that cost savings would be achieved through the Fit For Growth plan being implemented. The audit team failed properly to document its consideration of whether the Company was "*committed*" to the cost saving programme assumed in the Restructuring Case, within the meaning of IAS 36, paragraph 47.

4.23 Further, management made certain adjustments to the Restructuring Case to produce the Covenant Case, which reflected management's updated view of the forecast period in light of the refinancing in April 2018. There is no evidence on the audit file of consideration given by the audit team to whether these adjustments to the Restructuring Case should be reflected in the impairment review calculations and related audit conclusions.

4.24 The audit file indicates that the figures in the "Group centre/adjustments" line were not included in the individual CGU value-in-use calculations. There is no evidence in the workpaper of consideration given by the audit team to whether this approach was appropriate.

4.25 The above matters constituted breaches of paragraph 8 of ISA 230 in that the audit team failed to prepare sufficient audit documentation relating to the nature, timing and extent of the audit procedures performed and the results of those procedures; the audit evidence obtained; and significant matters arising during the audit, the conclusions reached thereon, and the significant professional judgments in reaching those conclusions.

## 5. THE ROLE OF MR LOWE

5.1. As noted at the outset, Mr Lowe was the senior statutory auditor on the audit engagement. In his capacity as engagement partner for the FY 2015, FY 2016 and FY 2017 audits, he was responsible for the overall quality of the audits; took responsibility for their direction, supervision and performance in compliance with professional standards and applicable legal and regulatory requirements; and was under a personal obligation to consider whether sufficient appropriate audit evidence had been obtained. Accordingly, he was responsible for the adverse findings set out above.

## 6. SANCTIONS

6.1. The FRC Sanctions Policy (Audit Enforcement Procedure) summarises the approach to determining sanctions, which involves the following steps:

6.1.1. Assess the nature and seriousness, gravity and duration of the breach found by the Decision Maker and the degree of responsibility of the Respondent(s) for the breach;

6.1.2. Identify the sanction or combination of sanctions that the Decision Maker considers potentially appropriate having regard to the breach identified in a) above;

6.1.3. Consider any relevant aggravating or mitigating circumstances and how those circumstances affect the level, nature or combination of sanctions under consideration;

6.1.4. Consider any further adjustment necessary to achieve the appropriate deterrent effect;

6.1.5. Consider whether a discount for admissions or early disposal is appropriate; and

6.1.6. Decide which sanction(s) to order and the level/duration of the sanction(s) where appropriate.

6.2. Paragraph 11 provides that:

> *"In determining the appropriate sanction, a Decision Maker should have regard to the reasons for imposing sanctions for a breach of the Relevant Requirements in the context of the Audit Enforcement Procedure. Sanctions are imposed to achieve a number of purposes, namely:*
> *a) to declare and uphold proper standards of conduct amongst Statutory Auditors and Statutory Audit Firms and to maintain and enhance the quality and reliability of future audits;*
> *b) to maintain and promote public and market confidence in Statutory Auditors and Statutory Audit Firms and the quality of their audits and in the regulation of the accountancy profession;*
> *c) to protect the public from Statutory Auditors and Statutory Audit Firms whose conduct has fallen short of the Relevant Requirements; and*
> *d) to deter Statutory Auditors and Statutory Audit Firms from breaching the Relevant Requirements relating to statutory audit."*

6.3. Paragraph 12 provides that: "*The primary purpose of imposing sanctions for breaches of the Relevant Requirements is not to punish, but to protect the public and the wider public interest*."

6.4. The Executive Counsel identified the following combination of Sanctions as appropriate for Grant Thornton:

6.4.1. A declaration that the audit reports do not satisfy the audit reporting requirements;

6.4.2. A published statement, in the form of a severe reprimand;

6.4.3. An order pursuant to rule 96(c) of the AEP whereby Grant Thornton is ordered to report to its FRC supervisor for a period of 2 years on the results of a monitoring programme of the quality of audit work on loss-making contracts; and

6.4.4. A financial sanction of £1.3 million, adjusted for aggravating and mitigating factors, including exceptional cooperation, by a reduction of 15% and a further 35% discount for admissions and early disposal, resulting in a financial sanction to be paid of £718,250.

6.5. The Executive Counsel identified the following combination of Sanctions as appropriate for Mr Lowe:

6.5.1. A published statement, in the form of a severe reprimand;

6.5.2. A declaration that the Statutory Audit Reports for the Audits did not satisfy the *Relevant Requirements*; and

6.5.3. A financial sanction of £70,000 adjusted for aggravating and mitigating factors, including exceptional cooperation, by a reduction of 15% and a further 35% discount for admissions and early disposal, resulting in a financial sanction to be paid of £38,675.

6.6. In reaching this decision, the Executive Counsel has, in summary, considered the following matters in accordance with the Sanctions Policy.

Nature, seriousness, gravity and duration of the breaches

6.7. The Adverse Findings concern breaches of *Relevant Requirements* which are designed to ensure the quality and effectiveness of an audit, some which are fundamental to the work of an auditor.

6.8. The Company was a large, high-profile business with a number of public-sector clients. There was therefore a significant public interest in a proper audit of the Company.

6.9. Certain breaches of the same nature had been identified in previous Audit Quality Reviews and communicated to Grant Thornton in previous years. Further, Grant Thornton has been the subject of recent enforcement action in which breaches of *Relevant Requirements* have been identified.

6.10. However, none of the breaches set out in the Decision Notice was dishonest, deliberate or reckless and the Respondents did not derive any financial benefit from the alleged breaches, aside from the audit fees.

6.11. The breaches in relation to FY 2015 and FY 2016 were more serious than those in relation to FY 2017. EfW contracts had been identified as a significant risk in the audit plan, and estimated losses in respect of the Glasgow Contract were substantial. The audit evidence obtained by Grant Thornton did not adequately support key judgments and accounting estimates made by the Company. In some instances, the evidence was absent; in others it was of poor quality; in others the evidence directly pointed against recognition of certain amounts by the Company.

6.12. In respect of one subset of breaches (concerning recognition of estimated recoveries under the OCS claim), these were repeated over two financial years.

6.13. The Respondents' failure to conduct these aspects of the audits in accordance with Relevant Requirements could harm investor, market and public confidence in the truth and fairness of the financial statements published by Statutory Auditors or Statutory Audit Firms. The fact that Grant Thornton and Mr Lowe failed to conduct these aspects of the audits of a Public Interest Entity in accordance with Relevant Requirements could harm confidence in the conduct of those who conduct statutory audits more generally.

6.14. That said, the Executive Counsel does not assert that the breaches resulted in the financial statements being materially misstated. The breaches were limited to discrete areas of the audit, and they do not indicate a failure in Grant Thornton's policies and procedures.

6.15. As to FY 2017, although the failures occurred in critical areas of the audit, namely the going concern and goodwill impairment assessments, none of the breaches gives rise to fundamental doubt about the accuracy of those assessments and they are at the lower end of the spectrum of seriousness and gravity.

6.16. Grant Thornton has taken remedial actions to prevent similar breaches in the future. Grant Thornton's remedial actions have focused on developing a loss-making contract methodology with an on-going monitoring programme to assess its effectiveness. Although not arising as a result of the breaches identified in this investigation, Grant Thornton has introduced a formal policy relating to use of experts on going concern and the documentation of this work. Further, the firm has engaged in work to address failures in scepticism and challenge. If the remedial action being taken by Grant Thornton is effective, the Executive Counsel considers the likelihood of the breaches recurring to be low.

<u>Aggravating factors</u>

6.17. There are no aggravating factors that have not already been considered in the context of the seriousness of the breaches of the *Relevant Requirements*.

<u>Mitigating factors</u>

6.18. The Executive Counsel has taken the following mitigating factors into account, in addition to those identified above in the context of seriousness:

6.18.1. Both Mr Lowe and Grant Thornton have demonstrated contrition and have apologised for the breaches of Relevant Requirements.

6.18.2. Mr Lowe has a good compliance history and disciplinary record. The FY 2017 audit of the Company was his last audit following a 43-year career in the profession.

6.18.3. The Respondents have offered an exceptional level of cooperation throughout the investigation.

Deterrence

6.19. The Executive Counsel does not consider that any further adjustment for deterrence is necessary.

Discount for Admissions and Early Disposal

6.20. Having taken into account the full admissions by the Respondents and the stage at which those admissions were made (at an early point within Stage 1 of the case in accordance with paragraph 84 of the Sanctions Policy), the Executive Counsel has determined that a reduction of 35% to the financial penalty is appropriate. The Executive Counsel has therefore applied a reduction of 35% for admissions and early disposal in respect of both Grant Thornton and Mr Lowe.

Other considerations

6.21. In accordance with paragraph 47(c) of the Sanctions Policy, Executive Counsel has taken into account the size / financial resources and financial strength of Grant Thornton and the effect of a financial penalty on its business.

## 7. COSTS

7.1. Executive Counsel requires that the Respondents pay her costs of £467,780. Such costs shall be paid no later than 28 days after the date of the *Final Decision Notice*.